

DRAFT DCI BRIEFING FOR
SENATE FOREIGN RELATIONS COMMITTEE

THE SOVIET ECONOMY

- I. The Soviet economy is large, and it continues to grow.
 - A. Since 1958 its Gross National Product has been about one-half that the United States.
 - B. The Soviets, however, allocate their output by standards which differ greatly from ours.
 - C. Their allocations stress the elements of national power. They give high priority to the continuing modernization of their military forces, to space programs, and to modernization of industrial capacity.

(CHART, US and Soviet GNP by end use)

1. Thus, as this chart shows, in dollar values Soviet spending for defense and for investment approaches our own. The portion of their investment allocated to industry, in fact, exceeds our own.
2. When it comes to consumption, however, a Soviet population which is almost one-fifth larger than ours gets less

~~SECRET~~

than one-third of what is spent for consumption here.

3. The consumer's welfare is further reduced by the poor quality and assortment of goods, and by his lack of choice; for example, the consumer would prefer additional housing, but he cannot get more housing by voting with his rubles in the market place.

II. While the Soviet economy continues to grow, a general slowdown has become evident in recent years.

(CHART, US and Soviet Annual GNP growth rates)

- A. The Soviet GNP growth rate, which was averaging about seven percent a year in the late 1950's, works out to about four percent a year for the early 1960's.
 1. The 1964 increase was a healthy five to six percent, but a substantial part of this apparent growth is merely the recovery from the poor performance in 1963, when a near-disaster in agriculture kept GNP growth down to less than two percent.

~~SECRET~~

~~SECRET~~

(CHART, Industrial Production, US vs. USSR)

2. In industry, 1964 saw the continuation of the slow decline in rates of growth from eight-and-one-half- percent annually in the period 1956-59 to seven percent in 1960-62 and now to six percent. Official Soviet statistics, incidentally, confirm this decline in industrial growth, although the Soviet index of industrial production typically runs about two percentage points above our own calculations.
3. In contrast, US industrial growth was relatively slow from 1957 to 1961, but since 1961 has been about as fast as that of the USSR.
4. The pattern of growth in Soviet GNP in the present period, in summary, is a composite of:
 - (a) erratically fluctuating agricultural production with small long-term growth, and
 - (b) slowly declining growth rates in industry.

~~SECRET~~

~~SECRET~~

B. Two major causes of the decline in the rate of growth of Soviet industrial production are, first, the inability of the Soviets to maintain the rate of growth of investment in new productive capacity, and second, the competition of defense spending for high-quality resources needed to support the modernization of industry.

1. The Soviet economy chronically runs at full throttle. When one activity is accelerated something else must slow down.

(CHART, Annual growth rates in investment and defense)

C. Thus, investments, which this chart shows growing at an impressive annual rate in the years when defense spending was curbed, declined after defense expenditures began to increase again.

1. It is interesting to note that when defense expenditures level off, as they did in 1963 and 1964, this halts the drop in the rate of investment growth.
2. The failure to maintain the growth of investment has caused the Soviet leadership to keep in service old factories

~~SECRET~~

and equipment that ordinarily would be scrapped. This "solution," of course, is only temporary and has had predictable effects in damping the growth of output per worker in industry.

III. Defense spending--in which we include the Soviet space program--is growing less rapidly in total right now, but it remains a problem for the whole economy.

(CHART, total defense expenditures and proportion devoted to exotics--R & D, adv. wpn. procurement, etc.)

- A. This is primarily because advanced weapons and space programs require the best and scarcest inputs of skilled scientists and engineers, new alloys and other high-cost materials, and the most advanced industrial processes.
- B. These are the very inputs which are also needed to carry through the modernization of the civilian economy, and in this key area the competition for critical resources remains intense.
- C. In this competition, the civilian economy fares rather badly. Our best measure of

~~SECRET~~

this is our estimate of the increases in Soviet spending on military research and development, the space program, and the procurement of advanced hardware for missiles, radars, and nuclear weapons.

(CHART, Spending for R&D, etc.)

1. As can be seen quite clearly in this chart, these expenditures are growing much faster than total military spending. They have just about doubled since 1958.
2. Within this trend, the procurement has tended to level off, but Research and Development spending continues to rise. This supports the point I made earlier that the Soviets are putting great stress on achievement of qualitative improvements.

D. Mr. Kosygin in his economic report last month announced a cut in the defense budget of 500 million rubles (about 550 million dollars); however, other items in the budget--such as scientific research--conceal additional spending on defense programs. These

~~SECRET~~

~~SECRET~~

concealed items are more likely to rise than those in the announced budget. In general, we believe that there will be a slow increase in Soviet defense spending over the next few years.

IV. Another basic difficulty of the Soviet economy, of course, is agriculture, which exerts a drag on the whole economy.

A. The problems here are chronic--a long history of neglect, the inherent deficiencies of the collective farm system, some real limitations in soil and rainfall, and the difficulty of training enough skilled farm managers and mechanics and of keeping them down on the farm. We believe that a number of programs for more fertilizer and more mechanization will fall short of desired results for lack of enough skilled people and the motivation for carrying out the programs.

(CHART, Total and per capita agricultural production)

B. Crop production made a considerable recovery in 1964, but livestock did not, so that total agricultural production last year was

~~SECRET~~

~~SECRET~~

about at the level of 1961. On a per capita basis, of course, with the constant increase in population, it was lower than either 1961 or 1958, the two relatively good years on the chart.

C. In mid-1963, Khrushchev sponsored a large crash program for the "chemicalization" of the economy. This chemical program was aimed at aiding agriculture by raising the annual production of chemical fertilizers from 20 million metric tons in 1962 to 35 million in 1965 and to 70 million metric tons by 1970; in addition, large increases in plastics and man-made fibers were scheduled. The new leadership has already modified this program in important particulars--softening the "crash" elements in the program, reducing sharply the increase of investment scheduled for 1965, and acting very cautiously in taking up the long-term credits available for importing equipment from the West.

V. There is also a more general reason for this slowdown with which the Soviet economic planners have to contend.

~~SECRET~~

~~SECRET~~

A. The Soviet economy is becoming more developed and mature. It has already drawn from the land to the cities most of the excess rural workers agriculture could spare. By and large, the easiest technological gains have been made, including those gains taken over lock-stock-and-barrel from the US and Western Europe. Further technological gains will require more domestic R&D--and more resources.

B. As a result, every percent of future growth is a little harder to achieve. To put it another way, each unit of new capital and additional man hours produces an increase in production, but each year the gain from these extra inputs is a little smaller.

(CHART, Direction of Soviet foreign trade)

VI. One of the consequences of all this can be seen in what has happened in the area of Soviet foreign trade.

A. The Soviets have been trying to increase their industrial imports from the West--everything from large diameter pipe to entire industrial complexes--as you are

~~SECRET~~

~~SECRET~~

well aware, and as you can see from the bottom segment of each of these bars.

(CHART, Soviet financing of hard currency deficits)

B. For these industrial imports from the West, the Soviets have had to depend on medium-term credits. Their exports have not been generating enough hard currency to cover imports. This last year, payments of interest and principal just about matched new extensions of medium-term credits, so there was no net gain in ability to import.

C. The medium-term debt piled up in this way has grown rapidly since 1959. Last year it reached some 620 million dollars.

(CHART, Soviet gold production, sales, and reserves)

D. Another way the Soviets have paid for their imports is with gold. This has led to an almost precipitous drop in their gold reserves. By the end of 1964, these were down to only about one and a half billion dollars.

E. When Khrushchev started to push hard with his program for the chemical industry in the middle of 1963, he knew he would have

~~SECRET~~

~~SECRET~~

to get machinery from the West, and that he would have to get it on credit--long-term credit.

- F. The new leaders are cutting back the chemical program somewhat, and are not pushing very hard at present for long-term credits.
 - 1. We think they will probably not resume the drive for long-term credits until they are more sure of their needs for the period of the next Five Year Plan--from 1966 through 1970--and have a better idea of their export potential.
- G. The Soviet "trade drive" in the underdeveloped countries has also slacked off. Trade between the USSR and a selected group of developing nations rose substantially during the past decade, but there are no major new initiatives at present.
- H. Exchanges of important raw materials and manufactured goods with other Communist countries still account for more than 70 percent of Soviet trade. The sharp reduction in trade with Communist China has been offset by increased exchanges with Eastern European countries.

SECRET

~~SECRET~~

(CHART, Soviet aid to Free World countries)

VII. While Soviet trade with the developing countries has fallen off, Soviet aid--which is more responsive to long-term policy considerations--is a vigorous and active program. This chart shows the scope of Soviet military and economic aid to Free World countries over the ten years that the Soviet Union has been engaged in the program.

- A. The blue bars represent extensions of economic aid, and the blue line linking them shows the extent to which these commitments have been fulfilled by deliveries. The red bars represent military aid agreements, under which delivery has generally been completed with little delay.
- B. As the USSR enters its eleventh year of aid activity in the Free World, the program is becoming increasingly complex, the immediate returns less discernible, and Moscow has learned by experience that a foreign aid investment does not guarantee a return in the currency of political influence.
 - 1. Moscow is, however, committed to maintain its old programs, and remains ready

~~SECRET~~

~~SECRET~~

to consider aid for newly emerging states. Assistance to non-Communist countries was favorably reviewed by Soviet leaders in 1962 and 1963, and Khrushchev's fall is not expected to cause any modification of the foreign aid program.

2. After two years of relatively low extensions of new economic aid, the Soviet Union in 1964 again topped \$1 billion--largely due to sums offered to underwrite new five-year plans which start this year, such as Egypt's. Aid extended in 1964 amounted to \$860 million for Communist countries and \$820 million for Free World countries.

- C. The bulk of Soviet economic aid to the free world is focused on relatively few underdeveloped countries--those which Moscow believes are the most promising economically, and whose political policies are most compatible with long range Soviet aspirations. However, new programs are initiated when exploitable circumstances occur, as in Africa today. The Soviets are also now competing with Communist China in Africa.

~~SECRET~~

~~SECRET~~

D. While deliveries under the aid program grow, repayments are beginning to reduce the impact on the economy and the burden of current exports on credit. (Almost all Soviet economic and military aid is extended under loans that are to be repaid).

SECRET

~~SECRET~~

VIII. Soviet military aid frequently is given with less restraint than economic credits. It places less burden on the economy and it serves immediate political objectives more rapidly.

A. One-half of all military aid to non-Communist nations has gone to two pivotal countries--Egypt and Indonesia--whose political policies, while not necessarily consonant with those of Moscow, have discomfited the West.

1. The Middle East is generally committed to bloc arms. The development of the United Arab Command--dominated by Egypt--probably assures Moscow of preeminence in Middle East military programs. For example, Nasir is pressing Jordan and Lebanon to obtain MIG jet fighters.
2. Current military assistance to Indonesia continues to maintain a toe hold for the Soviets in Asia.
3. The USSR, learning by experience, is proceeding cautiously with military aid for new, unsophisticated, and politically volatile African states.

~~SECRET~~

~~SECRET~~

B. The Soviet military aid program continues, however, to grow in scope and content. Advanced weapons systems now are a standard export item. The USSR continues to supply advisory missions, and to expand the training of free world military officers at its institutes, and is now supplying arms production facilities, for instance, a MIG jet fighter factory for India.

~~SECRET~~

~~SECRET~~

IX. Economic problems certainly had something to do with Khrushchev's fall.

- A. We have no evidence, however, that his successors are planning any major changes for this year in the pattern of economic allocations.
- B. We are highly skeptical of the announced cut in defense expenditures for 1965.
- C. In his speech last month, Mr. Kosygin promised an expansion of housing construction in 1965 by some 10 percent over 1964. Such promises have usually been underfulfilled in recent years.
- D. There are two areas, however, where some changes have been in motion--economic organization, and economic thought.
 - 1. Organizationally, the new leaders are already busy trying to undo some of what they have referred to as Khrushchev's "hare-brained schemes"--for example, the division of the Communist party into separate industrial and agricultural organizations.
 - 2. They are also experimenting with the ideas of Professor Liberman and others who would like to see profits and the market play a much greater role in guiding production.

~~SECRET~~

~~SECRET~~

3. Recently it was announced that four hundred plants in the garment and footwear industry are to operate under a system giving the plant manager much greater freedom in determining the quality, the assortment, and even the prices of the factory's output.

D. Obviously, Marxism-Leninism is not going to tell the Soviets how to solve their problems. On the contrary, they are now in fact rifling the storehouse of Western ideas for ways and means of coping with their economic difficulties.

VIII. While the Soviet economy has slowed down pretty much across the board in recent years, the growth has by no means come to an end.

A. Western, and Yugoslav, ideas will help to the extent that the Soviet Union actually adopt them. (Czechoslovakia and other East European countries, incidentally, show signs of putting more Westernized concepts into practice in their economies.

B. Some of the things the Soviets are trying in agriculture are intelligent. Barring bad weather, agricultural production should rise--perhaps an average of three to four percent a year over the next five years or so.

~~SECRET~~

~~SECRET~~

- C. Our analysis by no means suggests that the Soviet economy will be unable to sustain a vigorous military and space program.
1. These expenditures may level off, or even shade down a little, between now and 1970. On the other hand, they might continue to rise by as much as 20 percent. In either event, the strain on scarce resources is going to remain, and perhaps even grow.
 2. In short, we are not prepared to forecast that economic pressures are driving the Soviet Union into a corner where it will be willing to accept new arms control measures.

IX. Our best guess is that the growth of Soviet Gross National Product for the rest of this decade will average between four and six percent a year. Just where it falls within this range will be determined to a considerable degree by weather and its effect on agriculture, and by future trends in defense spending.

- A. In any case, the more general problems of industrial maturity and backward agriculture are going to make it difficult to sustain a six

~~SECRET~~

~~SECRET~~

percent rate of growth, and the rate is very unlikely to regain the seven percent level characteristic of the mid-1950's.

- B. The performance we envisage by the Soviet economy is not going to satisfy the Soviet leaders, and it will help stimulate renewed conflict within the Kremlin.
- C. At the same time, however, it will not really provide much comfort for us, because whatever the difficulties, it will continue to furnish the Soviets the necessary wherewithal for their challenge to the Free World.

SECRET